EX PARTE OR LATE FILED

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Federal Communications Commission
Office of Secretary

April 29, 1997

Mr. William F. Caton, Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

EX PARTE: Access Reform (CC Docket 96-262)

Dear Mr. Caton:

Attached for filing in the above-captioned docket please find a response prepared by Kirkland & Ellis for GTE Service Corporation to the ex parte filings recently made by the Competition Policy Institute (CPI) and MCI Communications Corp. Both CPI and MCI have submitted memoranda arguing that reducing access charges by relying on a purely forward-looking cost method of calculating the charges will raise no takings concerns under the Fifth Amendment.

The attached response demonstrates that the arguments both CPI and MCI have presented rely on critically flawed interpretations of Supreme Court precedents. Contrary to CPI's and MCI's suggestions, a switch to a purely forward-looking cost method for determining access charges is not wholly insulated from scrutiny under the Takings Clause. Rather, by denying LECs any opportunity to recover large portions of their actual investments, such a rate will necessarily deny LECs a constitutionally required fair return on investment, and thus result in a taking of LECs' property in violation of the Fifth Amendment.

CPI has also launched a belated attack on the arguments presented by Professors Sidak and Spulber demonstrating that an abrupt switch in rate methodology that would deny incumbent LECs any opportunity to recover their historical costs will also breach the regulatory contract between the Commission and incumbent LECs. Because the arguments surrounding that issue have been thoroughly aired in previous filings, GTE will not address them further here.

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Please associate this letter and its attachment with the captioned docket. In accordance with Section 1.1206(b)(1) of the Commission's Rules, I am filing two copies of this notice with your office.

Please call me if you have any questions.

Sincerely,

Whitney Hatch

Attachment

c: Chairman Reed E. Hundt
Commissioner Rachelle B. Chong
Commissioner Susan Ness
Commissioner James H. Quello
Mr. James Coltharp
Mr. Daniel Gonzalez
Mr. James Casserly
Mr. Thomas Boasberg
Ms. Regina Keeney
Mr. A Richard Metzger, Jr.
Ms. Kathleen B. Levitz
Mr. William Kennard

AN ANALYSIS OF THE TAKINGS IMPLICATIONS OF THE FEDERAL COMMUNICATIONS COMMISSION'S PROPOSED PRESCRIPTIVE REDUCTIONS IN ACCESS CHARGES

CC DOCKET NO. 96-262

Prepared for GTE Service Corporation
By Kirkland & Ellis

The Competition Policy Institute (CPI) and MCI have filed memoranda with the Commission attempting to rebut the arguments that GTE Service Corporation and other local exchange carriers (LECs) have advanced demonstrating that basing access charges purely on forward-looking costs will result in an unconstitutional taking of LECs' property. At GTE's request the following response has been prepared to show that CPI's and MCI's efforts to predict for the Commission "how a court would rule," CPI Mem. at 1, on the constitutional questions raised by the LECs are based on fundamentally flawed interpretations of Supreme Court precedents.

CPI's and MCI's arguments are based largely on two fundamental errors.

First, CPI and MCI suggest that under the Supreme Court's decisions applying a "total effect" test in ratemaking cases the ratemaking method selected by the Commission will be irrelevant to constitutional analysis. Thus, they urge the Commission to believe that wholly ignoring historical costs would raise no constitutional concerns. Contrary to these exaggerated claims, however, the Supreme Court has never suggested that a rate method that systematically precludes any consideration of the actual costs incurred by a utility to provide service could survive constitutional scrutiny. To the contrary, precisely because such a rate method would categorically prohibit LECs from recovering large portions of their actual investments, the overall effect of the rate would be to deprive LECs of a constitutionally adequate return. Moreover, particularly where a utility has been required to make investments in the past under government supervision in order to provide service under standards defined by the government, a switch to a rate method that would ignore those investments cannot be squared with the constitutional requirement that utilities be allowed a fair return on the property they have devoted to public service.

Second, CPI argues that even if the Commission's proposed switch to a forward-looking cost method for access charges were to result in losses for LECs from their operations in offering exchange access, that result would raise no constitutional concern because LECs' profits from other lines of business will ensure that the LECs' overall financial integrity is not impaired. See CPI Mem. at 3. This argument ignores the long settled principle that a regulated entity cannot be required to operate the regulated segments of its business at a loss on the theory that profits from its competitive activities may compensate for confiscatory rates. See, e.g., Brooks-Scanlon Co. v. Railroad Comm'n, 251 U.S. 396, 399 (1920).

I. Switching To A Forward-Looking Cost Methodology for Setting Access Charges Would Result in an Unconstitutional Taking of LECs' Property.

It is well settled that under the Fifth Amendment a utility must be allowed a rate that will permit it to "'maintain its financial integrity, to attract capital, and to compensate its investors for the risk [they have] assumed.'" Duquesne Light Co. v. Barasch, 488 U.S. 299, 310 (1989) (quoting FPC v. Hope Natural Gas Co., 320 U.S. 591, 605 (1944)). That "fair return" standard indisputably requires rates that will cover not only operating expenses, but also "capital costs" including "service on the debt and dividends on the stock." Hope, 320 U.S. at 603. By categorically prohibiting any consideration of historical costs, however, basing access charges solely on forward looking costs will guarantee that LECs are precluded from recovering a substantial portion of the actual investments they have made in their networks and thus will necessarily deprive LECs of a constitutionally adequate return. Obviously, there can be no return to investors (as required by the Constitution) if LECs are deprived, across the board, of their ability even to recover their capital outlays. See Teneco Oil Co. v. Department of Consumer Affs., 876 F.2d 1013, 1020 (1st Cir. 1989) (to meet constitutional standard, "rates must provide not only for a company's costs, but also for a fair return on investment").

Moreover, taking into account actual historical investments in judging whether LECs have been allowed a fair return is particularly important because LECs have been required to make investments in the past under requirements set by government regulators (both local and federal). LECs are not entirely free to decide whether and when to invest in their networks, or whether and how their networks should be expanded. Rather, they have been required for years to meet universal service requirements and minimum service standards set by regulators. LECs cannot, therefore, limit or time their investments in the network based solely on economic considerations or the advent of new technology. To switch now to a ratemaking method that would ignore historical investments (and thereby eliminate any opportunity to earn a return on them) would plainly violate the constitutional requirement that the LECs be allowed a fair return on the property they have dedicated to public use.

CPI's and MCI's arguments in support of a switch to a forward-looking cost approach ignore the straightforward implications of settled takings analysis and distort the meaning of the Supreme Court's decisions. For the reasons outlined below, their arguments can provide no support for a switch to a forward-looking cost method of determining access charges.

A. The "Total Effect" Test In No Way Immunizes From Constitutional Infirmity A Rate-Making Methodology That Ignores Historical Costs.

Both CPI and MCI place near-total reliance on language from the Supreme Court's decision in Duquesne Light Co. v. Barasch, 488 U.S. 299 (1988), suggesting that "it is not the theory" of a rate order that matters for constitutional analysis, but rather the "total effect" of the order. See Duquesne, 488 U.S. at 310 (quoting FPC v. Hope Natural Gas Co., 320 U.S. 591, 602

(1944)). From that language, CPI and MCI derive the sweeping proposition that since methodology is irrelevant, there can be no constitutional impediment to setting access charges based solely on forward-looking cost method that wholly ignores historical costs. See CPI Mem. at 2; MCI Mem. at 1.

The Duquesne Court, however, did not suggest anything like that result. To start with, the Court simply did not address a situation in which a rate-making body proposed systematically to exclude from consideration in setting a rate base all historical investments made by the regulated entity. To the contrary, at issue in Duquesne was a change in rate methodology that excluded from the rate base only certain investments that, although prudent when made, were not currently "used and useful" in providing service. The primary impact of the change was to preclude the utility in question from earning a return on amounts invested in a proposed, but discontinued, nuclear power plant. See Duquesne, 488 U.S. at 302-03. The Court was careful in describing the limited scope of the issues before the it and based its holding quite explicitly (and quite narrowly) on the de minimis impact that this particular change in rate methods would have on the utility's revenues. The Court explained that the sums invested in the discontinued construction of the nuclear plant amounted to only 1.9% of the utility's rate base, id. at 312, and that the rate method would "reduce its annual [revenue] allowance by 0.4%." Id. The Court then held that "[g]iven these numbers," the "overall impact of the rate orders . . . is not constitutionally objectionable" because "these slightly reduced rates" would not deprive the utility of the constitutionally required fair return. Id. at 618.

Nowhere did the Duquesne Court proceed from that limited holding to suggest that a rate methodology could systematically exclude all consideration of the utility's actual "used and useful" historical costs and survive constitutional scrutiny. While the Court reaffirmed the statement from Hope that "'[i]t is not the theory but the impact of the rate order which counts," the Court did not attribute to that rule anything like the sweeping impact advocated by MCI and CPI. Instead, the Court cautioned that "[t]his language, of course, does not dispense with all of the constitutional difficulties when a utility raises" a takings claim. Id. at 310. As Chief Justice Rehnquist, writing for the Court, acknowledged, "the amount of capital upon which the investors are entitled to earn that [fair] return" was a question that itself has "constitutional overtones." Id. The proposal to base access charges solely on forward-looking costs, of course, involves precisely a question of the amount of capital on which LECs can earn a return and thus implicates the very constitutional limits of which the Duquesne Court warned.

Moreover, Justice Scalia, in a concurring opinion joined by Justice O'Connor, expanded on the Court's caveat and explained why, even under the "total effect" test, evaluating the constitutional effect of a rate order might well require considering historical costs. As Justice Scalia explained, since the Constitution requires that a utility be allowed a "fair return on investment," regardless of the method used in setting rates, judging the ultimate effect of the rates under the Constitution requires using some minimum measure of the company's investment against which returns may be judged to be "fair." Duquesne, 488 U.S. at 317 (Scalia, J., concurring). And for that purpose, "all prudently incurred investment may well have to be counted." Id.

In short, as Justice Scalia's concurrence makes clear, nothing in the Court's opinion in Duquesne remotely holds that a rate method systematically precluding consideration of historical costs could survive constitutional scrutiny. To the contrary, the Court's analysis suggests that by ignoring the most critical touchstone for determining whether rates meet the constitutional standard of providing a fair return, such a rate method might well ensure that regulated entities would be denied a return that satisfies the minimum required by the Takings Clause. Indeed, as noted above, consideration of historical costs is particularly necessary in this context because LECs have been required to make their past investments to satisfy the requirements of government regulators. Those investments were made under a regulatory regime that ensured LECs would be able to earn a fair return. To switch now to a method that ignored the actual amounts invested would plainly deprive incumbent LECs of a fair return on the property they have dedicated to public use.

B. Switching From An Historical Cost-Based Approach to Access Charges to a Forward-Looking Cost Approach Would Create Artificial Losses for LECs And Plainly Result in a Taking Under Duquesne.

A switch to a forward-cost approach in setting access charges would raise exceptionally clear constitutional concerns in this context because of the regulatory history of access charges. Incumbent LECs have for years been subject to both state and federal regulatory systems designed to provide a return based on historical costs. As part of the federal system of regulating access charges, the Commission has set strictly controlled rates at which incumbent LECs can depreciate their assets and recover capital outlays. The depreciation schedules set by the Commission, moreover, like depreciation schedules set by the States, have artificially delayed LECs' recovery of their expenditures. LECs have thus accumulated undepreciated capital accounts reflecting amounts that federal accounting rules have not yet allowed them to recover. By switching now to a new rate method that would utterly ignore historical costs, the Commission would ensure that these amounts would be lost to the LECs forever. The Supreme Court warned in Duquesne, however, that such a switch between rate methodologies that would generate a wholly artificial loss on investments must "raise serious constitutional questions." 488 U.S. at 315.

CPI erroneously urges the Commission to find support in Duquesne specifically for the proposed switch to a forward-looking cost approach for access charges.[1] According to CPI, the

[1] CPI also suggests that the Commission should take comfort in what CPI calls the Supreme Court's "highly permissive approach to the facts." CPI Mem. at 2. It is not entirely clear what this unflattering characterization of the High Court's approach to adjudication is meant to convey. CPI apparently intends to suggest, however, that, because the Duquesne Court approved a rate method even though it found that the method would result in a loss to utilities on some prudent investments, the Commission should feel safe in basing access charges on forward-looking costs even if it results in "substantial" reductions in LECs' interstate revenues. As

facts in Duquesne are "particularly analogous" to those raised here because the regulator in Duquesne switched from a historical cost/prudent investment approach to setting a rate base to a "used and useful" rule and the "used and useful" test required "regulators to adopt a forward-looking approach similar to that required by the TSLRIC standard proposed by the FCC." CPI Mem. at 3.

Once again, however, CPI has flatly mischaracterized Duquesne. The Supreme Court, indeed, went out of its way in Duquesne to explain that "Pennsylvania determines rates under a slightly modified form of the historical cost/prudent investment system" under which property was still valued "in the rate base according to its historical cost." 488 U.S. at 310 & n.7. The switch to a "used and useful" standard merely eliminated a regulated entity's ability to earn a return on some prudent investments that were not "used and useful." All valuation, however, was still based on historical costs. See id. Thus, contrary to CPI's suggestions, nowhere in Duquesne did the Court address a switch from a traditional historical cost-based ratemaking system to a system (such as that proposed by the Commission) that would ignore historical costs across the board in favor solely of forward-looking costs. More importantly, the Pennsylvania Commission has long used the used and useful test to determine what portion of historical cost to include in the rate base. See, e.g., Pennsylvania Pub. Utils. Comm'n v. Philadelphia Elec. Co., 37 P.U.R. 4th 381, 387 (Pa. P.U.C. 1980) ("[W]e established a two-part test that must be met prior to the allowance of a return on particular investment: the evidence must show . . . (2) that the property invested in will be used and useful during the time the rates will be in effect."); Bell Tel. Co. v. Pennsylvania Pub. Utils. Comm'n, 408 A.2d 917, 925 (Pa. Commw. Ct. 1979) ("If the Commission reasonably finds that a particular class of property is not used or useful in serving the public, it may exclude the value of that property from the rate base and thus disallow the utility's return on that property.")

II. LECs Cannot Constitutionally Be Expected To Provide Exchange Access At A Loss On the Theory That Revenues From Intrastate Services Or From Other Competitive Lines of Business Will Make Up the Shortfalls.

The second major premise underlying CPI's arguments is also fatally flawed. CPI wrongly contends that under the "total effect" test of Hope and Duquesne, the constitutional effect of any change in the method of calculating access charges can only be assessed after taking into account the financial results of all of a LEC's operations. Thus, CPI suggests that any losses for LECs engendered by the Commission's switch to a forward-looking cost approach will not raise any constitutional concerns because the losses can be offset by LECs' performance in other lines of business. CPI therefore argues that "LECs are multi-product firms which can earn

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explained above, however, the holding in Duquesne was explicitly based on the miniml effect the rate order involved there had on the utilities' overall revenues. That holding in no way suggest that Duquesne offers regulators carte blanche to make substantial cuts in utilities' revenue requirements.

a return on their networks in a number of different ways," including through "local exchange services." CPI Mem. at 3. See also id. n. 2 (suggesting that even if the Commission were to prescribe "significant reductions in access charges," LECs would have no ground for complaint because they could make up shortfalls from "local exchange and exchange access services" and even from "new lines of business").

Such arguments wholly disregard over half a century of settled precedent in rate-making takings cases. To begin with, even when all of a company's activities are subject to a comprehensive system of government price regulation, it is well-settled that the rates set by a federal regulator must recover all of the regulated entity's costs for providing the service that is subject to federal jurisdiction. A federal regulator cannot provide a confiscatory rate and expect that constitutional problems will be solved because a state regulator will provide the business a sufficient return on intrastate services to make up the shortfall. To the contrary, each jurisdiction must cover its own costs. See, e.g., Smith v. Illinois Bell Tel., 282 U.S. 133, 148-49 (1930); see also Chicago, M. & St. P. Ry. v. Public Utilities Comm'n, 274 U.S. 344, 350-51 (1927). The costs of operating a LEC's local exchange network that are attributable to the interstate jurisdiction (and thus properly recoverable through access charges) have already been determined under the separations process. If the Commission fails to provide full recovery of those costs, it cannot, as CPI suggests, simply expect that LECs' revenues from local exchange service will make up the difference.[2] Rather, under settled law, failure to provide full recovery of those interstate costs will result in an unconstitutional taking of LECs' property.

That, however, is not the only flaw in CPI's argument. As all aspects of telecommunications services, including local exchange service, are opened to competition, the paradigm used in Hope Natural Gas for applying the "total effect" test (the paradigm on which CPI relies) will simply no longer be applicable. In Hope it was assumed that the total effect of a rate would be assessed by looking at all of a utility's regulated operations in the particular jurisdiction. That approach made sense when a regulated entity was granted an exclusive franchise for its operations and a regulator could make up for noncompensatory rates in one area of business by providing protection from competition and guaranteeing a higher return in other lines of business. When services are opened to competition, however, a regulator obviously cannot guarantee higher returns from competitive services in some areas to offset losses from noncompensatory rates in others. For that very reason, since long before Hope the Supreme Court has held that a regulated entity cannot be required to operate one line of business at a loss on the theory that profits from its competitive activities would make up the shortfalls. See, e.g., Brooks-Scanlon Co. v. Railroad Comm'n, 251 U.S. 396, 399 (1920) (Holmes, J.); see also

[2] Nor could the Commission circumvent the requirement that it provide a full return by asserting that in the past costs have been disproportionately allocated to the interstate jurisdiction as a means of providing a subsidy to support universal service. Until costs are reallocated under the statutory separations process, the costs that have been assigned to the interstate jurisdiction remain real costs that must be recovered through federal regulation.

Norfolk & W. Ry. v. Conley, 236 U.S. 605, 609 (1915).

Thus, CPI's suggestion that the impact of any reductions in access charges will properly be assessed only after taking into account LECs' profits from all lines of business (including local exchange service and even new entry into the long distance market) utterly ignores long-settled precedent. Far from providing any reasoned basis for distinguishing the principles from Brooks-Scanlon, moreover, CPI does not even acknowledge the case. Plainly, the Commission should not accept CPI's invitation to change the method for calculating access charges based on a theory that CPI has made no effort to reconcile with governing Supreme Court case law.

III. CPI's Remaining Arguments Are Makeweight.

CPI resorts to a series of additional arguments all of which are makeweight and only one of which merits discussion here. CPI attempts to confuse the issues before the Commission by citing takings cases that involved land use regulations. See CPI Mem. at 3-4 (citing Lucas v. South Carolina Coastal Council, 505 U.S. 1003 (1992)). Lumping together these cases concerning so-called "regulatory takings" with ratemaking cases, CPI attempts to suggest that there can be no taking, even in a rate case, if the restriction imposed by the government were "inherent in the background legal regime." CPI Mem. at 4. CPI then proceeds to suggest that even if basing access charges on forward-looking cost results in "severe financial hardship" for LECs, CPI Mem. at 4, that would raise no constitutional concerns since investors knew that the LECs' rates "would be subject to regulatory review" and courts "could deny a takings challenge for that reason alone." Id. That is nonsense. It should be patently obvious such an approach to takings analysis in rate cases is utterly circular. In this view, there is no constitutionally required minimum fair return that regulated companies must be afforded, since a lower return could always be justified by arguing that investors would have anticipated the possibility of government action in a highly regulated industry. That approach flies in the face of the Supreme Court's repeated clear holdings that the Takings Clause defines a minimum return that regulated entities must be allowed to avoid confiscatory rates. CPI's arguments distort that clear precedent by importing principles from a wholly distinct line of cases and can provide no sound basis for the Commission to conclude that basing access charges on forward-looking costs would not result in a taking.